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Date: March 10, 2005

AP 95

To: Audit Personnel

From: David Rock

VIA: Otis Fields

**Subject: Government Contractor Sale for Resale Exemption and Refund Procedures
Based on the Day Zimmerman/Raytheon Court Decisions**

Based on the Texas Court of Appeals, Third District, At Austin in the Raytheon E-Systems, Inc. vs Carole Keeton Strayhorn, No. 03-02-00346-CV, the General Counsel of the Comptroller's Agency has determined that no sales or use tax should be assessed on items that qualify for the sale for resale exemption. The qualification requirements for an exemption from the assessment of tax and the refund of tax are different. The requirements are explained below.

Background:

The fundamental issue in these cases is sale for resale to the federal government on items indirectly consumed by the defense contractors in the completion of both federal contracts and commercial contracts. We view all such claims as, primarily, Tax Code issues with the FAR (Federal Acquisition Regulations) filling in some of the ambiguities. For example, the Tax Code definition of a sale is the "transfer of title or possession..."(Sec. 151.005 (1)) but no definition of transfer of title is given. In these cases, there is no transfer of possession (items are consumed by the defense contractor and the cost is allocated to both commercial and federal contracts) so the transfer of title issue is important.

Direct Charges to a Government Contract that Qualify for Exemption

The Comptroller has long held that items directly charged to a government contract qualify for exemption as a sale for resale. The FAR title transfer clauses that address direct materials are;

52.245-2 Direct Materials charged or allocated to a general Fixed Price contract. All materials charged directly to such contracts are exempt from both sales and use taxes.

52.245-10 Direct Materials charged or allocated to maintain a government owned facility. All materials charged directly to maintain the government facility and taxable services directly charged to maintain the government facility are exempt.

In-Direct Materials Allocated to Qualifying Government Contracts

These were the primary type of charges that were addressed in the Raytheon E-Systems court case. A copy of the appeals court decision is attached (AP 95-A) for further discussion, but in short the FAR clauses the Court held to pass title are **FAR 52.232.16 Fixed Price with Progress Payments** clause and **52.245-5 Cost Reimbursements** clause. The judges made no distinction as to the type of overhead property other than that it must be tangible property which is addressed in the title passage clauses relating to these types of contracts. It makes no difference if the property is toilet paper, pencils, desks or computers, the contractor needs only to establish that the purchases were made and the allocated charges can be traced to a contract containing the title passage clauses list above. This is a fairly broad category and issues will arise that need further clarification. If you are in doubt on these issues or have any questions on any part of the process, please contact the manager of Technical Support. The manager will disburse the questions and answers to others in the program so that we can be as consistent as possible when dealing with this issue.

Items That Do Not Qualify for this Exemption as a Sale for Resale under the Title Passage Clauses

Capitalized equipment does not qualify for the resale exemption since title does not transfer under the FAR clauses listed above even if the annual depreciation is passed on as an allocated charge.

Intangibles, rentals, and taxable services do not qualify for the resale exemption. (Note: Some taxable services may qualify in contracts relating to government owned facilities that contain the 52.245-10 clause if the services are passed directly to the federal government and relate to government owned facilities.)

Computer software licenses do not qualify for the sale for resale exemption in most cases. This is due to the fact that title never passes on the software, only the right to use the software is conveyed to the purchaser and in most cases the government contractor is the user of the software, not the federal government. (There are some cases where software is specifically developed for use by government personnel but title to this type of software normally will pass to the government under 5.245.2 addressing items directly charged to a government contract.)

NOTE: These guidelines are general in nature and are not intended to address all situations that might come up. As with any new implementation, more detailed guidelines will follow as the issues arise and are addressed by the agency. If you have specific questions contact the manager of Technical Support.

Requirements for Refund of Tax

In addition to the verification procedures listed above, refund requests require additional documentation. The additional documentation is the same as that required by agency guidelines on any other refund but must also include the following:

An assignment of the right to receive the refund from the federal government or copies of credit memos issued to the federal government by the defense contract must be accompanied by written acceptance from the federal government. The written acceptance from the federal government must be signed by someone with the authority to obligate the federal government. In general, the Contracting Officer for the government will be the individual qualified to obligate the federal government. They should also include a copy of the Certificate of Appointment of the Contracting Officer. Examples of the [Certificate of Appointment \(AP95-B\)](#), [Credit Memorandum \(AP95-C\)](#), [Credit Memorandum Acceptance Letter \(AP95-D\)](#) and a [Credit Memo Acceptance, Release and Waiver form \(AP95-E\)](#) are attached.

Additional Issues for Auditors

Listed below are some additional instructions for the situations that are currently known to exist. We know that many additional issues will need to be addressed and as they come up we will provide updated instructions. Please contact audit headquarters any time you have a specific issue not already addressed in these instructions so we can update the information for other auditors working these assignments.

1. Begin all refund work with a request to the taxpayer for a full list of all contracts (federal and commercial) in the refund/audit period and the federal contracts that the taxpayer has concluded are qualifying contracts under Day & Zimmerman/Raytheon case guidelines. On the qualifying contracts, obtain or verify the following:

- Verify that each contract contains one or more of the qualifying FAR's (Federal Acquisition Regulation) listed previously.
- Verify that each qualifying contract is for an actual sale to the U.S. Federal Government.
- Request a Contract Brief with annual summaries that support the allocation of general & administrative cost, government participation percentages included in final indirect cost claims, and any procedures for allocation of indirect cost pools and intermediate cost pools.

(Note: The allocation percentages that have been disclosed and accepted by the Federal Government will be acceptable to the State.)

2. Any disputed contracts should be separated and forwarded to Audit HQ for final qualifying determination. Send the contract information to the manager of Technical Support and it will be reviewed by legal counsel.
3. Request a list of any federally owned or federally leased property used by the contractor in the performance of the qualifying contracts.
4. Establish the allowable statute period for the refund under current Agency policies. Any statute disputes not resolved at the local level should be referred to Audit HQ for final resolution. No vendor refund assignment forms are required for these refunds unless the contractor requesting refund is non-permitted. If the contractor is non-permitted they should go back to their vendor for refund or obtain a vendor refund assignment before they can come to us for the refund.
5. Request a list from the taxpayer of any manufacturing refunds, economic development refunds and Franchise tax credits based on the manufacturing phase in received by the taxpayer in the refund period. Also review the taxpayer histories for this type of information and any refunds taken directly on the taxpayer's returns in other periods.
6. Determine if any audits were completed during the refund period. Review those audits to determine if any tax was assessed on consumable items used on qualifying government contracts. Determine if the current refund request addresses the tax assessed in those audits, if any.
7. Determine the amount of Texas (state and local) taxes paid on qualifying overhead materials.
 - Review a sample of vendor invoices for qualifying overhead material purchases. The sample may be determined by the state or the taxpayer, but it must conform to current Audit guidelines and policies. A stratified random sample using CAMS is recommended in all cases where it is workable.
 - In the verification of tax paid, be sure to spot check some of the vendor's files to make sure the tax has not been refunded or credited to the contractor and that the items were not returned to the vendor for credit. Verify that tax accrued was not reversed on any items claimed in the refund.
 - The assumption on these refunds is a purchase for resale, therefore it is irrelevant if the tax was paid to the vendor directly or accrued and reported on the return of the contractor. If tax was paid to the vendor directly it is important that the correct local allocations be established due to the impact on local communities.

- Some examples of potentially qualifying overhead materials are:
 - purchased parts (batteries, resistors, transistors, etc.)
 - raw materials (metal, plastic, copper, etc.)
 - equipment and materials (not capitalized or depreciated) (test tubes, chemicals)
 - low value plant equipment (not capitalized or depreciated)(timers, meters, etc.)
 - hand tools (hammers, screwdrivers, drills, etc.)
 - janitorial supplies (soap, paper towels, cleaning chemicals, not janitorial services)
 - low value office equipment (not capitalized or depreciated)
 - office supplies (stationery, printed forms, paper clips, etc.)
 - maintenance & repair services to tpp owned by the federal government
 - Some examples of potentially non-qualifying overhead materials are:
 - capital assets (capitalized or depreciated)
 - utilities (electric, gas, sewer, telephone) Note: some utilities are specifically exempted by statute.
 - rentals of any type
 - taxable services (except repair & restoration/maintenance of govt. owned prop.)
 - any taxable items not reimbursed by the federal government
 - any item on which tax was paid to another state
8. Total tax paid on qualifying overhead materials established by the sample will have to be multiplied by the percentage of qualifying overhead materials allocated to government contracts (all government contracts percentage) then multiplied by the percentage of qualifying government contracts that meet the criteria in item #1. (Note: The percentage of qualifying government contracts will need to be verified/established during the audit.)
9. The tax subject to refund calculated in item # 8 must be reduced by any prepayment or timely filing discounts taken on the refundable amounts.
10. See AP 94 - Verification Procedures for Government Contracts for Day & Zimmerman/Raytheon Sales for Resale Exemption and Refund. This document contains specific information on what parts of the contract are required to verify the qualifying FAR clauses.

Attachments:

1) (AP95-A) Texas Court of Appeals, Third District, At Austin Raytheon E-Systems, Inc., Case #03-02-00346-CV*

2) [\(AP95-B\) Certificate of Appointment](#)

3) [\(AP95-C\) Credit Memorandum](#)

4) [\(AP95-D\) Credit Memorandum Acceptance Letter](#)

5) [\(AP95-E\) Credit Memo Acceptance, Release and Waiver](#)

*Because the Comptroller is not the legal custodian of court cases, we can not include the actual document as an attachment to this memo. For your convenience, however, we have provided the legal cite to this case:

Carole Keeton Strayhorn, Comptroller of Public Accounts of the State of Texas,
and Greg Abbott, Attorney General of the State of Texas/Raytheon E-Systems,
Inc., Appellants v. Raytheon E-Systems, Inc./Carole Keeton Strayhorn,
Comptroller of Public Accounts of the State of Texas, and Greg Abbott, Attorney
General of the State of Texas, Appellees

NO. 03-02-00346-CV

COURT OF APPEALS OF TEXAS, THIRD DISTRICT, AUSTIN

2003 Tex. App. LEXIS 870

January 30, 2003, Filed

Texas Third Court of Appeal's Web site: www.3rdcoa.courts.state.tx.us